No. 18,449

In the United States Court of Appeals for the Ninth Circuit

WESTERN CREDIT COMPANY, INC.,
a corporation, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 141-159) are reported at 38 T.C. 979.

JURISDICTION

The petition for review (R. 162-166) involves personal holding company surtaxes for the calendar years 1949 to 1953 and income taxes[1] for the calendar year 1954 and for the fiscal periods ended

[1] The personal holding company surtax was computed as part of the income tax for these periods.

April 30, 1955 and 1956, respectively. On May 21, 1959, the Commissioner of Internal Revenue mailed to the taxpayer notice of deficiencies in personal holding company surtaxes and income taxes in the total amount of $32,014.36. (R. 17-31.) Within ninety days thereafter and on August 17, 1959, the taxpayer filed a petition with the Tax Court for a redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939 and Section 6213 of the Internal Revenue Code of 1954. (R. 7-16.) The decision of the Tax Court was entered September 28, 1962. (R. 160.) The case is brought to this Court by a petition for review filed December 24, 1962. (R. 162-166.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court correctly held that so-called contract charges constituted "interest" and thus "personal holding company income" to the taxpayer within the meaning of Section 502 of the Internal Revenue Code of 1939 and Section 543 of the Internal Revenue Code of 1954 and that the taxpayer was therefore subject to personal holding company taxes for the years involved.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

> SEC. 541. IMPOSITION OF PERSONAL HOLDING COMPANY TAX.
>
> In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable

year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to the sum of—

(1) 75 percent of the undistributed personal holding company income not in excess of $2,000, plus

(2) 85 percent of the undistributed personal holding company income in excess of $2,000.

(26 U.S.C. 1958 ed., Sec. 541.)

SEC. 542. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) *General Rule.*—For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if—

(1) *Gross income requirement.*—At least 80 percent of its gross income for the taxable year is personal holding company income as defined in section 543, and

(2) *Stock ownership requirement.* — At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. * * *

* * * *

(26 U.S.C. 1958 ed., Sec. 542.)

SEC. 543. PERSONAL HOLDING COMPANY INCOME.

(a) *General Rule.*—For purposes of this subtitle, the term "personal holding company income" means the portion of the gross income which consists of:

(1) *Dividends, etc.*—Dividends, interest, royalties (other than mineral, oil, or gas royalties), and annuities. This paragraph shall not apply to interest constituting rent as defined in paragraph (7) or to interest on amounts set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act, 1936.

* * * *

(26 U.S.C. 1958 ed., Sec. 543.)

Sections 500, 501 and 502 of the Internal Revenue Code of 1939 are substantially identical with the portions of Sections 541, 542 and 543 of the 1954 Code, respectively, quoted above, and are applicable here.

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.543-1 *Personal holding company income.*

(a) *General rule.* The term "personal holding company income" means the portion of the gross income which consists of the classes of gross income described in paragraph (b) of this section. * * *

(b) *Definitions.*— * * *

(2) *Interest.* The term "interest" means any amounts, includible in gross income, received for the use of money loaned. * * *

* * * *

Section 39.502-1 of Treasury Regulations 118 (1939 Code) is substantially identical with the portion of Section 1.543-1 of Treasury Regulations on Income Tax (1954 Code) set forth above.

STATEMENT

The relevant facts (some of which were stipulated (R. 34-39)) as found by the Tax Court (R. 142-148) may be stated as follows:

The taxpayer, incorporated in 1948 under the laws of Montana, has its principal place of business in Great Falls, Montana. (R. 142.) Operating under the general corporation statutes of that state, it was engaged in the business of making small loans to individuals during the years here involved. All of its gross income, except a small amount of rentals, was derived from borrowers in the operation of its business. (R. 142-143.)

In the taxpayer's business, many potential borrowers were refused loans on the basis of the perliminary interview conducted by the taxpayer's manager at the taxpayer's office, and no loan applications were received from them. However, if a person submitted an application, the manager, as he explained the details of the loan to the borrower, prepared a work or scratch sheet showing the amount of the loan together with the calculation and amount of charges which became a part of the taxpayer's records and files. (R. 143.)

One such charge was termed a "contract charge". It was $10 if the principal amount of a loan was

$100 or less, and was $15 or three per cent of the loan principal, whichever was greater, for a loan in a principal amount exceeding $100. (R. 143.)

Another charge, also computed on the worksheet, was a "carrying charge" of one per cent per month of the principal sum, calculated in advance, for the duration of the loan when a loan was for $100 or more, or $1.67 per month when the principal of the loan was under $100. This charge was computed separately from the contract charge. (R. 143.)

Additional charges were also computed on the sheet for filing or recording fees for chattel mortgages securing the loan, insurance premiums for life insurance on the borrower's life, and for premiums for automobile insurance, when the loan was to be secured by a chattel mortgage on an automobile. (R. 144.)

If the loan application was accepted, the borrower executed a promissory note in a face amount equal to the total of the amount of the loan, the carrying charge, the contract charge, and any other charges or fees (R. 144) "collected." [2] The note was payable in equal monthly installments over a stated period. No breakdown of the face amount appeared on the note; it provided only for interest at the rate of eight per cent per annum after maturity until paid. (R. 144.)

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[2] The word (R. 144) "collected" obviously does not mean that the fee had already been collected from the borrower. Instead, it evidently refers to fees paid by the taxpayer which were to be collected from the borrower. (See R. 38-39, 146-147.)

The taxpayer's manager, in detailing a loan for a borrower, always explained that the amount of the contract charge would be "used up" in processing the application for the loan. If the borrower made payment of his loan before the installments were due, he received a rebate for a proportionate part of the carrying charge, but did not receive a rebate for any part of the contract charge. (R. 144.)

The taxpayer investigated the credit of every borrower. (R. 144.) Generally, the taxpayer checked with the local credit bureau and then with some of the borrower's creditors to spot check the borrower's information and paying habits. (R. 145.) However, when the credit bureau had no record, as was usually the case when the borrower was from out of town, the taxpayer's manager would contact the borrower's creditors or credit bureau in the borrower's home city, or refer the matter to the local credit bureau for forwarding to the out-of-town bureau. In either case, the taxpayer incurred toll charges for telephone calls or an additional charge by the local credit bureau based on the work involved in handling the inquiry. (R. 145-146.)

The taxpayer accepted as loan collateral various types of tangible personalty, such as automobiles (often on automobile purchase loans), furniture, equipment, and livestock. It always checked the identity, value, and title of such properties. The taxpayer's manager often traveled to the location of such properties to investigate them. (R. 144-145.) Also, from a service it subscribed to and from per-

sonal investigation, the taxpayer checked the loan value of automobiles offered as collateral. From another service, it checked the title of such automobiles licensed out of state. The taxpayer's manager handled the payment of the necessary taxes and fees, the claiming of tax credits on out-of-state cars, and the obtaining of licenses and titles in order that the taxpayer's chattel mortgages on the automobiles would be in order. The manager took powers of attorney from borrowers in order to make applications for titles. (R. 145.)

Where a borrower made a "consolidation" loan, the taxpayer in many instances paid off his creditors directly and obtained releases of security instruments such as chattel mortgages where such payments were made in discharge of the borrower's debts. Often these releases were prepared by the taxpayer. Also, the taxpayer sometimes performed services for customers by taking wage assignments from them, collecting portions of their incomes, and discharging their debts from the collected wages. (R. 146.)

Except for the contract charge and the carrying charge, the taxpayer did not charge borrowers for the foregoing services. The contract charge was intended to defray the taxpayer's expenses incurred in performing these services, although there was no direct relation between the amount of the contract charge and the cost of performing services in connection with any particular loan. (R. 146.)

Collections from borrowers were applied first to principal until it was paid in full. (R. 146.) There-

after, the receipts were entered on the taxpayer's records under the following categories:

1. Collected fees.
2. Bad debt recovery (including principal of the bad debt).
3. Extra interest collections (used on extensions of loans).
4. Insurance premium income.
5. Miscellaneous income (recording fees, notary fees, etc.).
6. Overages.

The taxpayer reported gross income in the foregoing categories for the years involved. (R. 147.)

The account entitled "collected fees" included receipts from both the contract charge and the carrying charge. (R. 147.)

In each of the years involved, the contract charges exceeded twenty per cent of the taxpayer's gross income. (R. 147.)

Neither the contract charge, the carrying charge, nor any other charge was specifically allocated on any of the taxpayer's books and records to any particular expense of the business. The expenses incurred by the taxpayer in the operation of its business were itemized on its tax returns and included salaries, interest, advertising, rent, filing fees, rebates, bad debts, and other expenses normally incurred in the operation of a business. (R. 147.)

The expenses the taxpayer incurred in the operation of its business were covered by all the income received. (R. 147.)

On July 28, 1954, the present owners of the taxpayer purchased the stock originally held by one of the taxpayer's incorporators under a contract which limited the right of the taxpayer to declare dividends. (R. 148.)

During the years involved, more than fifty per cent in value of the outstanding stock of taxpayer was owned by five or fewer individuals. (R. 142.)

The Commissioner determined that at least eighty per cent of the taxpayer's gross income for the years involved was derived from interest and, its stock being held by not more than five individuals, that the taxpayer was subject to personal holding company surtaxes. (R. 17, 19, 148.)

The Tax Court, sustaining the Commissioner's determination, found as an ultimate fact that the taxpayer failed to prove that more than twenty per cent of its gross income during the years involved was other than personal holding income. (R. 148.) In particular, it held that the evidence failed to show that any part of the contract charges constituting at least twenty per cent of the taxpayer's gross income was a charge (R. 157) "truly separable from interest." Decision was entered accordingly (R. 160) and thereafter the petition for review was filed (R. 162-166).

SUMMARY OF ARGUMENT

The only question in the instant case is whether the taxpayer's gross income from so-called contract charges constituted interest income, as the Tax Court

held, or income from services rendered to borrowers, as the taxpayer contends.

It is clearly established by decisions of the Supreme Court, this Court and other courts and by the relevant regulatory provision, that the term interest, for tax purposes, has its commonly understood meaning, namely, the amount which one has contracted to pay for the use of borrowed money. It is not necessary that such an amount, to retain its character as interest, be specifically designated by creditor and debtor as interest or that it be payable in any specified manner if, in fact, it is an amount to be paid for the use of money loaned.

Applying the foregoing rules to the instant case, the contract charges constituted interest income to the taxpayer. The taxpayer charged all borrowers the carrying charge and the contract charge (the "collected fees") for the use of the money loaned to them, in lieu of a formal interest charge. There is no evidence that these charges constituted anything other than amounts to be paid for the use of the money. Such amounts, then, represented the *cost* to the borrowers of the money borrowed from taxpayer and constituted an integral part of the benefits flowing to taxpayer for the money loaned.

The contract charges are not excludable from interest income because allegedly imposed to cover the costs of investigating prospective borrowers' credit status or appraising properties offered as loan collateral. Since such costs are incurred to determine the lender's risk involved in making small loans to individuals, they inure primarily to the benefit of the

lender, for services rendered to itself and not to the borrower. Moreover, even if some small part of such costs were incurred for services rendered by taxpayer for borrowers, the taxpayer has failed to establish the nature of such services or the amount of the total contract charge attributable thereto. Accordingly, the Tax Court correctly concluded that taxpayer failed to prove that in excess of twenty per cent of its gross income was other than interest income. The cases relied on by taxpayer are distinguishable on their facts.

ARGUMENT

The Tax Court Correctly Held That the Contract Charges Here Involved Were Primarily Imposed On the Borrowers for the Use of the Money Lent To Them and, Therefore, That the Taxpayer Had Failed To Prove That More Than Twenty Per Cent of Its Gross Income Represented By Such Charges Did Not Constitute Interest and Thus Personal Holding Company Income

Section 500 of the Internal Revenue Code of 1939 [3] and Section 541 of the 1954 Code, *supra*, impose a surtax on the undistributed personal holding company income of personal holding companies. Section 542 of the 1954 Code, *supra*, defines a personal holding company to mean any corporation if at least eighty per cent of its gross income for the taxable year is personal holding company income and if more than

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[3] While 1939 Code years are involved in this case, inasmuch as the relevant portions of the 1939 and 1954 Codes are substantially identical, reference is hereafter made only to the 1954 Code.

fifty per cent in value of its outstanding stock is owned by not more than five individuals. "Interest" income is included in the definition of personal holding company income. Section 543(a), *supra.*

The only question before the Tax Court was whether the taxpayer's gross income from so-called contract charges, hereinafter described, received by it during the course of carrying on its small loan business, constituted "interest" within the meaning of the pertinent statutory provisions referred to above.[4] It was stipulated by the parties that taxpayer's gross income from the so-called contract charges exceeded twenty per cent of taxpayer's gross income in each of the tax periods involved, so if this income is not interest, less than eighty per cent of taxpayer's gross income would qualify as "personal holding company income" and taxpayer will not be liable for the surtax. On the other hand, if the income from contract charges is interest, the parties agree taxpayer was a personal holding company and subject to the tax. (R. 149.)

In the instant case, when a potential borrower came into the taxpayer's office, he was interviewed by the taxpayer's manager who determined whether an ap-

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[4] In the petition to the Tax Court, it was also contended that the taxpayer was exempt from classification as a personal holding company because of contractual limitations on its right to declare dividends, the absence of intent to avoid income tax to its shareholders, and because it was exempt under Section 542 as a personal finance or loan company. (R. 8-9.) These contentions were abandoned in the Tax Court. (R. 149-150, fn. 4; see also R. 162-165.) The stock ownership requirement of Section 542 was never in dispute. (R. 35-36, 142.)

plication for a loan was warranted. If the person submitted an application, the manager prepared a work or scratch sheet as he explained the details of the loan to the borrower. The worksheet, containing figures written by the manager, showed the amount of the loan together with the calculation and amount of charges, and became a part of taxpayer's records and files. (R. 143.)

One of the charges computed on the sheet when the loan was made was termed a "contract charge" and was equal to $10 if the principal amount of the loan was $100 or less, and was $15 or three per cent of loan principal, whichever was greater, for a loan in a principal amount exceeding $100. (R. 143.)

If the loan application was accepted, the borrower executed a promissory note in a face amount equal to the total of the loan, the carrying charge,[5] the con- the contract charge, and any other charges or fees collected, which note was payable in equal monthly installments over a stated period. No breakdown of the face amount appeared on the note and it provided only for interest at the rate of eight per cent per annum after maturity until paid. Taxpayer's manager, in detailing a loan for a borrower, always explained that the amount of the contract charge would be "used up" in processing the application for the

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[5] The carrying charge, also computed on the work sheet, was equal to one per cent per month of the principal sum, calculated in advance, for the duration of the loan when a loan was for $100 or more, or $1.67 per month when the principal of the loan was under $100. This charge was computed separately from the contract charge (R. 143).

loan. If the borrower made payment of his loan before the installments were due, he received a rebate for a proportionate part of the carrying charges, but he received no rebate of any part of the contract charge. (R. 144.)

In deciding the issue presented to it the Tax Court observed, citing *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, that interest is the amount which one has contracted to pay for the use of borrowed money. (R. 150.) It noted that a borrower from a small loan company is basically interested only in obtaining the use of the lender's money and is willing to pay what is required to obtain such use, and that the very nature of the small loan business is to make a profit in the form of interest on money loaned by it. (R. 157.) Accordingly, reviewing the relevant cases, the Tax Court concluded that unless it is proved that a charge imposed on the borrower is actually used to cover *the cost of rendering services to him* rather than to the lender (including the services the lender requires for the operation of its small loan business), such a charge is still a fee for the use of the lender's money, regardless of its formal designation. Applying the foregoing criteria to the facts of the instant case, the Tax Court further concluded that the taxpayer had failed to prove that all or at least twenty per cent of its gross income represented by the contract charges did not constitute interest income. (R. 148, 151-159.) Consequently, it sustained the Commissioner's determination that the taxpayer was taxable as a personal holding company for the years in question. (R. 148, 159.)

The taxpayer contends (Br. 11-12, 14, 15) that the contract charges were sufficiently related to services allegedly rendered by the taxpayer to its borrowers as not to constitute interest and that the Tax Court erred in concluding that (R. 158; Br. 12)—

> fees charged to borrower * * * to defray the ordinary and necessary expenses incurred by the lender in conducting a small loan business are [not] truly separable from interest.

We submit, however, that the Tax Court correctly decided the issue and that the taxpayer's contentions are without support in the statutes, Regulations or authorities.

While the 1954 Code uses the term "interest" in several of its provisions, e.g., Sections 163 and 543 (a)(1)) without defining it, the Treasury Regulations promulgated thereunder undertake to do so, with particular reference to personal holding company income, as "any amounts, includible in gross income, received for the use of money loaned." Treasury Regulations on Income Tax (1954 Code), Sec. 1.543-1(b)(2), *supra*. This regulatory provision is of long standing (see the predecessor Treasury Regulations 86, Art. 351-2(3)), and its validity is not directly questioned here. And, also according to the popular and commonly understood meaning of the word, applicable for tax purposes, the term interest, as we have indicated, denotes the amount one has contracted to pay for the use of borrowed money. *Deputy* v. *duPont*, 308 U. S. 488, 498; *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 560, 561; *Commissioner* v.

Columbia River P. Mills, 126 F. 2d 1009 (C. A. 9th). It is not necessary either that interest be designated as such or computed in a particular manner to retain its character as interest if it is in fact paid for the use of borrowed money. *Dorzback* v. *Collison*, 195 F. 2d 69, 72 (C. A. 3d); *Noteman* v. *Welch*, 108 F. 2d 206, 210 (C. A. 1st); *Kena, Inc.* v. *Commissioner*, 44 B.T.A. 217, 219-220, 221.

Applying the foregoing rules, which undertake to set forth the inherent nature of interest, to the instant case, it is clear that the contract charges in question constituted, as the Tax Court held, a portion of the aggregate amount which the borrowers contracted to pay the taxpayer for the use of the monies borrowed and thus interest. The taxpayer, however, did not *formally* charge its borrowers interest during the terms of the loans [6] for the use of the money lent to them. Instead, it imposed the so-called contract and carrying charges, which together, as (R. 147) "collected fees", accounted for substantially more than eighty per cent of the taxpayer's income during the years involved (R. 35, 103, Exs. 3-C - 10-J). As noted, these contract and carrying charges together with the principal amount of the loan constituted the face amount of the promissory notes executed by the borrowers. No breakdown of the face amount of these notes appear thereon. (R. 144.) Inasmuch as the borrowers, then, regularly paid as part of the

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[6] Interest was formally charged at eight per cent only after maturity of the promissory notes representing the amounts of the loan principal plus all charges and fees. (R. 38, 144; Exs. 21-U, 22-V.)

consideration for the use of taxpayer's monies these contract charges (after first making payment of the principal amount of the loan (R. 146-147)) on all the loans made by taxpayer, such charges come squarely within the definition of the term interest, as defined by the regulations and the relevant cases. They clearly represented the *cost* to the borrowers of the loans and nothing else. Certainly, had the borrowers attempted to deduct the payments therefor, it could hardly be argued that they represented something other than interest within the meaning of Section 163 of the 1954 Code. They were clearly an integral part of the benefits flowing to the taxpayer for money loaned and were paid by the borrowers in order to obtain the loans.[7]

The taxpayer, in light of the decision in *Noteman* v. *Welch*, *supra*, conceded below that it cannot exclude any portion of the *carrying* charges from the term interest, although it contends that a portion thereof does, in fact, represent services to the borrowers after the loan is set up. (Br. 21-22, 28; R. 46-47, 74, 95-96, 101, 124, 149, fn. 4.) But essentially the same considerations which preclude the exclusion of any part of the carrying charges from interest income also apply to the contract charges.

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[7] In this connection, it should be observed that the taxpayer's assertion (Br. 14) that its borrowers "understood" that the contract charges were not imposed "for the use of money" is unsupported in the record (R. 58, 73, 104). That the borrowers were perhaps *told* that the charges were necessary to cover the lender's expenses of determining the risk factor in making loans to them is obviously of no significance here.

As the Tax Court held (R. 156, 157-158), the contract charges were not allocated for specific services or expenses and, more important, were not shown to have been used to cover the cost of any specified services rendered for the benefit of the borrower.[8] It may be that the taxpayer considered the contract charges necessary to cover certain costs of conducting the small loan business, in particular, the cost of determining the risk factor involved in making a loan to its type of customer. (See R. 73, 77-78, 80, 102-103, 104-105, 109-110; App. Br. 31.) However, that the charges might be necessary in the taxpayer's small loan business to offset in part or in whole such costs, as it contends (Br. 21; R. 109), is no reason for excluding the contract charges from the interest income category. *Girard Inv. Co.* v. *Commissioner*, 122 F. 2d 843, 844-845 (C. A. 3d); *Bond Auto Loan Corp.* v. *Commissioner*, 153 F. 2d 50, 51-52 (C. A. 8th); *R. Simpson & Co., Inc.* v. *Commissioner*, 44 B.T.A. 498, 499, 500, affirmed *per curiam*, 128 F. 2d 742 (C. A. 2d), certiorari dismissed for want of jurisdiction, 321 U. S. 225; *Seaboard Small Loan Corp.* v. *Commissioner*, 42 B.T.A. 715, 719. As the court stated in the *Girard Inv. Co.* case, *supra* (pp. 844-845):

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[8] Even assuming *arguendo* that a small amount of the contract charge may have been paid for some services to the borrowers other than the advancement of monies there is clearly no evidence of record showing that such amount would account for twenty per cent of the taxpayer's gross income.

> With many small loans to the kind of people who need small loans the "effort of administration" and the "insecurity of payment" is more pronounced. The small loan companies have advocated and been granted rates covering this increased cost and risk. It is a *non sequitur* to use this justifiable excess in nominal interest as an argument in support of its own exclusion from the general word interest and the limitation of that word to *pure* interest.

The question of what constitutes interest under Section 351 of the Revenue Act of 1934, a predecessor of the instant statutory provision, was presented in *Noteman* v. *Welch*, 108 F. 2d 206 (C. A. 1st). There the taxpayer reported its income as (p. 210) "interest and charges for small industrial loans" and the Deputy Commissioner of Banks for Massachusetts testified that in arriving at a rate of three per cent per month, it was considered that two per cent was for operating expenses while one per cent would represent the amount paid for (p. 211) "the use of borrowed money". This idea was further supported by the printed form of note used which stated that approximately one per cent of the three per cent charged was for interest and approximately two per cent for expenses as defined in the Massachusetts law. In presenting its evidence at the hearing, the taxpayer divided its expenses into a number of headings including (1) investigation of borrowers and security, (2) closing of loans, papers, etc., and (3) servicing and collecting loans. As to the three items named, the taxpayer argued that these were related

directly to the cost of making, servicing and collecting the loans and certainly could not be considered as charges for interest. But the court, in refusing to adopt that view, said (pp. 212-213):

> In large part these charges are for services the lender renders, not to the borrower, but to himself, in deciding whether to make the loan, and in safeguarding the loan after it is made. * * *
>
> * * * There is the further difficulty that the charge for expenses in this case is a blanket charge assessed against all borrowers, whether or not the enumerated services are rendered to the particular borrower, and whether or not the enumerated expenses are incurred in connection with any particular loan. * * *
>
> In other words, responsible borrowers have to pay more for the use of the money borrowed —more interest—in order to enable the lender to absorb the overhead costs of investigating rejected applicants, rewriting loans for borrowers in difficulties, pursuing "skips", and writing off bad debts; just as an honest insured has to pay more for his insurance so that the insurance company can absorb the cost of fighting dishonest claims.
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> * * * *
>
> Judging from the description of the taxpayer's business in the record *it seems that the only real consideration which the ordinary small borrower receives is the use of the money, and certainly, from his point of view, that is what he pays for.* Apparently such a borrower would ordinarily be entitled under Section 23(b) to deduct from his own gross income the full 3 percent as "interest

> paid," if, as we think is clear, borrowers from a bank can make a similar deduction, for the contract of loan does not assign any specific portion of the payments to particular charges properly separable from interest. See *Old Colony Railroad Co.* v. *Commissioner*, *supra*. Presumably "interest" is used in Section 351 in the same sense as in Section 23(b). In fact, Section 351(b)(4) provides that "the terms used in this section shall have the same meaning as when used in Title I [Subchapters A-C of this chapter]." [Italics supplied.]

Contrary to the taxpayer's contention (Br. 19-23), we believe that in all important respects the instant case is indistinguishable from the *Noteman* case. In the present case, as in *Noteman*, the taxpayer imposed blanket charges on all borrowers regardless of whether its asserted enumerated expenses were incurred in connection with any particular loan. (R. 107-108, 114-116.) For example, it is clear that the contract charges had to cover the costs of investigations of prospective loans never made (a general overhead expense) at least as much as did the carrying charges, which were allegedly reserved for costs incurred after the loan was set up. (R. 73, 74, 119, 125, 126-127, 128, 129-130; cf. Pet. Br. 21-22.) Moreover, these contract charges were to defray the cost of services the taxpayer rendered not to the borrowers but to itself, as the Tax Court here held.

Also, in *Seaboard Loan & Savings Ass'n, Inc.* v. *Commissioner*, 45 B.T.A. 510, on facts similar to the instant case, except that there investigating fees were actually separately allocated on the taxpayer's books,

it was held that the rationale of the *Noteman* and *Girard Inv. Co.* cases, both *supra*, applied because the charges were primarily to defray the cost of services for the benefit of the lender, not services rendered the borrower, who received only the loaned money for the charges paid. See also *Virginia Loan & Thrift Corp.* v. *Commissioner*, decided May 10, 1943 (1943 P-H T.C. Memorandum Decisions, par. 43,226) (where a two percent of loan principal statutory investigation fee, payable in advance, was held not excludable from interest income because not related to a "particular investigation"); *United Finance Co.* v. *Commissioner*, decided May 8, 1943 (1943 P-H T.C. Memorandum Decisions, par. 43,224) (where fixed services charges were held to be interest income and thus personal holding company income).

For the reasons stated by the Tax Court (R. 156-157), *Workingman's Loan Ass'n* v. *United States*, 142 F. 2d 359 (C. A. 1st), is distinguishable on its facts. In holding that the initial charges there involved did not constitute interest income to the lender, the court observed (p. 361) "that a borrower may have costs in connection with procuring a loan over and above the interest charge." It emphasized that the charges in question were (p. 362)—

> adjusted to the amount and type of loan, *secured or unsecured*, and are *specifically allocated*, by *agreement* with the borrower, to the expense of "investigation, identification, inspection and appraisal." * * * [and] *paid in advance*. (Italics supplied.)

Thus, unlike the instant case and the *Noteman* case, *supra*, there was a factual basis of a sort in that case for the court's implicit conclusion that the initial charges there involved were (p. 361) "for service actually rendered" for the *benefit* of the *borrower*.[9] The court, recognizing the clear distinction between that case and the *Noteman* case, stated (p. 360), "We think that the facts presented in the present record are significantly different from the facts in the Noteman case * * *." In the instant case, it was the taxpayer that required and demanded that the contract charges be included in the face of the promissory notes before the money was loaned to the borrowers. Thus, the borrowers were required to submit to these charges even though they derived no benefit from the expenditure thereof by the taxpayer. The borrowers contracted to pay the charges to obtain the use or the loan of taxpayer's funds. The charges were, therefore, clearly interest payable to the taxpayer by the borrowers. The Tax Court so held and its decision supported by substantial evidence cannot be said to be clearly erroneous and should accordingly be sustained. *Commissioner* v. *Duberstein*, 363 U. S. 278, 291; *Goldstein* v. *Commissioner*, 298 F. 2d 562, 566 (C. A. 9th.)

The case of *Elk Discount Corp.* v. *Commissioner*, 4 T.C. 196, relied on by taxpayer (Br. 43, 44), is

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[9] Contrary to the taxpayer's suggestion (Br. 27-28), the charges involved in the instant case were neither paid nor collected in advance in the sense in which the word "paid" was used in the *Workingmen's Loan Ass'n* case, *supra*. (R. 38, par. 19; R. 144, 146-147.)

inapposite. The taxpayer there involved was not in the business of lending money and the buyers of automobiles were not interested in borrowing money from it. (4 T.C., p. 201). See also *Southeastern Finance Co.* v. *Commissioner*, 4 T.C. 1069, 1085, 1086, affirmed on another issue, 153 F. 2d 205 (C. A. 5th).

In view of the foregoing, it follows that the so-called contract charges here involved were received for the use of money loaned and thus constituted interest within the commonly understood meaning of that term. Accordingly, the taxpayer failed to prove that more than twenty per cent of its gross income was other than personal holding company income and, therefore, cannot prevail here. *Reineck* v. *Spalding*, 280 U. S. 227, 232-233; *Noteman* v. *Welch*, *supra*, p. 210.

CONCLUSION

For the reasons stated above, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

DATED:.....day of....., 1963.

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Attorney

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